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# In the Supreme Court of the United States

OCTOBER TERM, 1968

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No. 280

UNITED STATES OF AMERICA, PETITIONER

*v.*

SKELLY OIL COMPANY

---

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT*

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## BRIEF FOR THE UNITED STATES

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### OPINIONS BELOW

The findings of fact, conclusions of law and decision of the district court (R. 20–30) are reported at 255 F. Supp. 228. The initial opinion of the court of appeals (R. 37–44) and the majority (R. 47–48) and dissenting (R. 49–54) opinions on rehearing are reported at 392 F. 2d 128.

### JURISDICTION

The initial judgment of the court of appeals was entered on April 20, 1967 (R. 45). The United States' petition for rehearing was granted on June 26, 1967. (R. 33, 46). The judgment on rehearing was entered on April 3, 1968 (R. 55). On July 2, 1968, Mr. Justice

Brennan entered an order extending the time for filing a petition for a writ of certiorari to and including July 9, 1968. The petition was filed on July 9, 1968, and was granted on October 14, 1968 (R. 56). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## QUESTION PRESENTED

Whether respondent, a producer of natural gas, in computing its taxable income for 1958, was entitled, as the court below held, to deduct the full amount of overcharges ($505,536) it refunded to customers in that year, or whether the deduction should be reduced, as the government contends, by 27½ percent or $139,022, representing depletion claimed and allowed as a deduction in computing taxable income in the prior years when respondent had included the $505,536 in its gross income.

## STATUTE AND REGULATION INVOLVED

Sections 611(a), 613(a), 613(b)(1), and 1341(a) of the Internal Revenue Code of 1954, and pertinent parts of Section 1.1341–1 of the Treasury Regulations on Income Tax (1954 Code) appear in the Appendix, *infra*, pp. 31–34.

## STATEMENT

Respondent produces natural gas in Oklahoma. By order effective August 1, 1952, the Oklahoma Corporation Commission established a mandatory minimum price for sales of natural gas. In 1958, this Court ruled that the Oklahoma Commission was without jurisdiction. *Michigan Wisconsin Pipeline Co.* v. *Cor-*

*poration Commission of Oklahoma,* 355 U.S. 425. On remand, the Oklahoma Supreme Court vacated the minimum price order. In 1958, respondent paid $500,000 in settlement of a lawsuit one of its customers, Cities Service Company, brought against it, and it paid $5,536 to another of its customers, Dorchester Corporation, to compensate the latter for amounts it had been required to pay in a suit brought by a party to whom it had resold respondent's gas. These amounts represented excess amounts collected under the invalid minimum price order. (R. 13–17, 21–25, 38).

Respondent had included the $505,536 in its gross income as received during the taxable years 1952 through 1957, since it then claimed an unrestricted right to them. In determining its taxable income for each of those prior years, respondent had claimed and the Commissioner of Internal Revenue had allowed percentage depletion with respect to such amounts, at the rate of 27½ percent. The depletion deductions totalled $139,022. (R. 23–25, 38–39).

In its federal income tax return for 1958 respondent claimed the entire $505,536 as a deduction. In auditing the return, the Internal Revenue Service reduced otherwise allowable percentage depletion for such taxable year by $139,022, representing 27½ percent of $505,536. This resulted in an additional assessment of tax for the year 1958, which respondent paid together with interest. Thereafter respondent filed a timely claim for refund. This claim was not allowed, and the

instant suit for refund was timely commenced. (R. 12–13, 19, 25–26, 38–39).[1]

The district court sustained the government's position (R. 29–30). The court of appeals, however, reversed, holding that Section 1341 of the Internal Revenue Code of 1954 entitled respondent to deduct the full $505,536 (R. 37–44). After granting a rehearing (R. 46), two members of the court of appeals panel adhered to the original decision, and one judge dissented (R. 47–54).

The United States filed a petition for certiorari, which was granted on October 14, 1968 (R. 56).

## SUMMARY OF ARGUMENT

Every Internal Revenue Law since the adoption of the Sixteenth Amendment has required that income be returned and tax paid on an annual basis. The so-called "claim of right" doctrine is a corollary of the annual accounting system. It was developed to deal with the situation where a taxpayer in one taxable year receives money thinking it is his, but in a later period repays part or all of the amount. In such a case, the taxpayer is required to return the amount as part of his gross income in the year of receipt, and is allowed a deduction upon repayment. Until the adoption of Section 1341 of the Internal Revenue Code of 1954, that deduction could be claimed only in the year of repayment. Because this rule caused hardship for

[1] The deficiency notice and refund proceedings raised other issues with respect to respondent's 1958 tax liability. These questions were resolved by stipulation in the trial court and are not in issue here. See R. 19, 26, 31.

some taxpayers (who might, for example, be taxable in a lower bracket in the year of repayment), section 1341 was inserted in the Code.

Under section 1341, income which a taxpayer receives or accrues under a claim of right is included in gross income in the year of receipt or accrual, as under prior law. With respect to the allowable deduction, however, the taxpayer is given an alternative. It may, under section 1341(a)(4), claim the deduction in the year of repayment, as under prior law; or it may, under section 1341(a)(5), compute its tax for the year of repayment without the deduction, and then reduce the tax so computed by the amount of tax attributable to the inclusion of the repaid amount in the income of the earlier years. Respondent here relies on section 1341(a)(4).

Section 1341 applies if three conditions are met. These are: (1) "an item was included in gross income for a prior taxable year (or years)" under a claim of right; (2) "a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item"; and (3) the "deduction exceeds $3,000." The problem of statutory construction here is in the meaning of the word "deduction", for section 1341(a)(4) states that if the above three conditions are met, then the taxpayer computes its tax "with such deduction" for the year of repayment.

The purpose of the statute shows that the "deduction" referred to must be determined by other parts of the tax law. The error of the court of appeals re-

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sults from its confusion of the word "item" referred to in section 1341(a)(1) with the word "deduction" used in the succeeding three subsections. But nothing in section 1341 purports to define the "deduction" to which it refers. Section 1341 only states the consequences that follow if other provisions of the tax law allow a "deduction" as a result of the taxpayer being required to repay amounts previously received under claim of right.

The pertinent provision here is section 165(a) of the Internal Revenue Code of 1954, which provides for the deduction of losses. Under other provisions of the Code, however, the amount deducted cannot exceed the taxpayer's adjusted basis in the item that is the subject of the loss. Under accepted principles of tax accounting, respondent's adjusted basis is the amount previously included in gross income, less the depletion deduction previously claimed with respect to those amounts. This is illustrated by *Arrowsmith* v. *Commissioner*, 344 U.S. 6, where a taxpayer who had reported as capital gain amounts received upon liquidation of his corporation was required to treat his later payments to corporate creditors, as transferee of the corporate assets, as a capital loss, since they arose out of and were a consequence of the prior capital transaction.

The result below is also inconsistent with a long line of decisions which hold that taxpayers may not claim more than one deduction of the same amount. Respondent was first allowed a deduction of 27½ percent, as its depletion allowance, when it included

the receipts in income for the years 1952 through 1957. Yet, after part of those same receipts were repaid to its customers, respondent has been allowed to deduct 100 percent of the repayments, thus overlapping the prior depletion allowance. Every time a comparable situation has come to this Court, the result has been that the double deduction has been denied.

In the alternative, this case may be analyzed by allowing respondent a full deduction for the amounts repaid to its customers in 1958, but requiring it to add to its gross income for that year an amount equal to the depletion allowed in the years 1952 through 1957 with respect to the amounts repaid in 1958. Such an analysis would be consistent with the general principle that requires a restoration to income of amounts previously claimed as a tax deduction where they are later recovered by the taxpayer, or a change in circumstances shows that the deduction should not have been claimed. This, for example, occurs where a charity returns property to a donor, who previously had taken a charitable deduction with respect to his gift, or where a business accrues wages, which later go unclaimed. This Court, in *Rothensies* v. *Electric Storage Battery Co.*, 329 U.S. 296, 298, expressly stated its agreement with this rule. Moreover, in *Douglas* v. *Commissioner*, 322 U.S. 275, this Court reached a comparable result in sustaining a Treasury Regulation that requires percentage depletion taken on advance royalties on a mining lease to be restored to income if the lease is later terminated without production having occurred.

## ARGUMENT

This case presents essentially a question of proper tax accounting.

The problem may be approached (1) through the construction of a particular statutory provision, Section 1341 of the Internal Revenue Code of 1954. Or (2) it may be approached as essentially an accounting problem; *i.e.*, what is the proper treatment in terms of tax accounting where a repayment is made in a later year of an item received in an earlier year, where depletion was deducted with respect to the item in the earlier year in which it was received.[2]

Both considerations lead to the same result, and both support and reinforce each other. They are intertwined in the argument which follows.

### BOTH SECTION 1341 OF THE INTERNAL REVENUE CODE OF 1954 AND ACCEPTED PRINCIPLES OF TAX ACCOUNTING REQUIRE THAT RESPONDENT'S DEDUCTION BE IN THE AMOUNT OF THE SUMS REFUNDED TO CUSTOMERS LESS THE CORRESPONDING DEPLETION DEDUCTIONS PREVIOUSLY CLAIMED AND ALLOWED WITH RESPECT TO THOSE SUMS

#### A. RESPONDENT'S DEDUCTION IS TO BE DETERMINED BY THE PRINCIPLES THAT GENERALLY GOVERN THE ALLOWANCE OF DEDUCTIONS AND IS NOT DEFINED BY SECTION 1341 OF THE INTERNAL REVENUE CODE OF 1954

The practicalities of taxation require that accounts be rendered and taxes paid on a fixed periodic basis. "Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practicable

[2] No problem of "tax benefit" arises, since a full tax benefit was received when the depletion deduction was taken, and the tax rates were essentially the same in the several years involved.

operation." *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365. Thus, the federal income tax laws have, since the Sixteenth Amendment, been based on the annual accounting period. The present case presents an example of the need—which the Congress, the courts, and the Treasury have all recognized—to make appropriate adjustments for distortions that sometimes arise where the transactions of one taxable year are the product of what has gone before.

Analysis of the present problem must begin with the "claim of right" doctrine, which has been developed to deal with the situation where, as here, a taxpayer receives or accrues an amount in one year, thinking it is his, but in a later tax period is required to restore or repay some or all of it. In *North American Oil* v. *Burnet*, 286 U.S. 417, 424, the Court held that a taxpayer who received money "under a claim of right and without restriction as to its disposition * * * has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." This Court went on to say that if a taxpayer is later required to refund some part of the money, it is (*ibid.*) "entitled to a deduction from the profits of [the year when the refund is made] * * *, not from those of any earlier year." *United States* v. *Lewis*, 340 U.S. 590, and *Healy* v. *Commissioner* 345 U.S. 278, expressly held that the deduction may be claimed only for the year of repayment.

This remained the unqualified rule until the enactment of the Internal Revenue Code of 1954. Congress then added section 1341 to the Code because "[i]n

many instances of this nature the deduction allowable in the later year does not compensate the taxpayer adequately for the tax paid in the earlier year." [3] The operative provisions are in section 1341(a).[4] They provide as follows:

> If—
>
> (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
>
> (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
>
> (3) the amount of such deduction exceeds $3,000,
>
> then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
>
> (4) the tax for the taxable year computed with such deduction; or

[3] S. Rep. No. 1622, 83d Cong., 2d Sess., p. 118; H. Rep. No. 1337, 83d Cong., 2d Sess., p. 86.

[4] Section 1341(b)(2) provides that section (a) "does not apply to any deduction allowable with respect to an item which was included in gross income by reason of the sale or other disposition" of an item held for sale to customers in the regular course of business. There is an exception, however, for "refunds or repayments with respect to rates made by a regulated public utility * * *" that are required by a governmental body, a court order, or in settlement of litigation. Respondent's payments to Cities Service and Dorchester plainly fall within the exception to section 1341(b)(2) so that section 1341(a) does apply to this case. (See R. 15, 17.)

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

The scheme of the statute is readily apparent. The first three paragraphs state conditions that must be met if the statute is to be applied. The fourth and fifth paragraphs provide alternative rules for determining the tax consequences of restoration of an amount received under a claim of right in a prior taxable period, and set the taxpayer's liability at "the lesser" of the tax computed under each alternative. The first option, stated in section 1341(a)(4), allows a deduction in the year of repayment, as did earlier law. The second, which is in section 1341(a)(5), is the new rule whose adoption was the purpose of section 1341. Under this, if a smaller tax is produced, the taxpayer may reduce his tax for the year of repayment by the amount of tax which was paid on the receipt in the prior year.

In the present case the adjustment for the prior year under section 1341(a)(5) would clearly be in the amount of the tax resulting from the *inclusion* in income of the amount received *and* the *deduction*

of 27½ percent of that amount as percentage depletion—that is, the tax on 72½ percent of the amount received, which is the amount of tax respondent paid when it included the amounts in income in 1952 through 1957. Respondent, however, relies on the other alternative provided by the statute, section 1341(a)(4). This is, in all essence, the same as that which was available before the statute was passed.

The question then turns on the proper construction of section 1341(a). The key to this in the present context, we submit, is found in the fact that Congress used one word in section 1341(a)(1) and a different word in section 1341(a)(2), and in sections 1341(a)(4) and (5).

In section 1341(a)(1) the operative reference is to an "item" which was included in gross income for the previous year. In this case, the item which was included in gross income in the previous year was the amount which was received for the sale of gas. If the word "item" had been used in sections 1341(a)(2), (4), and (5), it might be difficult to contend that the amount of the deduction which those provisions allow is different from the amount specified in section 1341(a)(1). However, this is not what Congress wrote. In section 1341(a)(2), Congress provided that if "a deduction" is allowable—that is, a "deduction," whatever its proper amount may be, and not necessarily the same amount as the "item" referred to in section 1341(a)(1)—then the tax should be determined under section 1341(a)(4) by determining "the tax for the taxable year computed with *such deduction*" (emphasis supplied).

Thus, the section does not allow the deduction of the "item" to which section 1341(a)(1) applies, but does provide for the computation of tax using the "deduction"—whatever is the appropriate amount of the deduction, under all the circumstances—under sections 1341 (a) (2) and (4). Section 1341(a) is not itself a deduction provision. It merely provides that whatever deduction is allowable under other provisions of the statute shall be taken into account in carrying out the adjustment which section 1341 authorizes. Thus section 1341(a) sheds no light on the amount of the deduction, but we must look to other provisions of the statute, and to relevant decisions, in determining the answer.

The result reached below depends entirely on the conclusion of the majority of the court of appeals that the word "deduction" necessarily encompasses the full amounts that respondent repaid to its customers in 1958 (R. 41). But nothing in Section 1341 specifies the amount of the "deduction", or qualifies or enlarges that amount in any way. As the legislative materials emphasize, section 1341(a)(4) is only intended to codify the rule of *Lewis* and *Healy*. See S. Rep. No. 1622, *supra*, pp. 118, 451; H. Rep. No. 1337, *supra*, pp. 86–87, A294–A295. It is those cases and the other provisions that allow deductions in computing taxable income which must provide the point of reference for determining the "deduction" to which section 1341(a)(4) refers.

This conclusion is supported by the pertinent Treasury Regulations. Section 1.1341–1(a)(1) of the In-

come Tax Regulations (Appendix, *infra*, p. 32) provides that: "If, during the taxable year, the taxpayer *is entitled under other provisions of chapter 1* * * * to a deduction * * *," he may claim one of the options provided in section 1341 (emphasis supplied). It is also confirmed by the fact that section 1341 appears not in Subchapter B, where the deductions allowed in computing taxable income are set forth, but rather in Subchapter Q, which contains a variety of provisions best described by the subchapter title: "Readjustment of tax between years and special limitations." Indeed, the court of appeals majority opinion here expressly recognizes (R. 42) that in section 1341(a)(4) "Congress * * * enacted the existing rule as to current year deductions * * *." Accord *National Life and Accident Ins. Co.* v. *United States*, 244 F. Supp. 135 (M.D. Tenn.), affirmed on other issues, 385 F. 2d 832 (C.A. 6).

This makes it necessary to determine what deduction would be allowable if section 1341 had not been enacted, a question that the court of appeals majority failed to analyze adequately. The pertinent principles provide two distinct approaches, each, however, yielding the same result. First, the issue may be analyzed simply as a problem of determining a loss deduction. It is clear under the established principles of tax accounting that such a deduction is limited to 72½ percent of the amounts respondent repaid to its customers in 1958. Or, second, the transaction might be analyzed by allowing a deduction for the full amount repaid, but requiring the restoration of the previously allowed percentage depletion to income in

the year of repayment, since gross income must include amounts for which a tax benefit has been claimed if events of a later year negative the basis for the earlier claim of a deduction. Compare *Douglas* v. *Commissioner*, 322 U.S. 275. We shall devote the remainder of this brief to a discussion of these alternatives.

B. SECTION 165 OF THE INTERNAL REVENUE CODE OF 1954 REQUIRES THAT RESPONDENT'S LOSS DEDUCTION BE LIMITED TO 72½ PERCENT OF THE AMOUNTS REFUNDED TO CUSTOMERS IN 1958

We begin with the elementary proposition that a taxpayer has the burden of bringing its claim of a deduction within some specific statutory provision, *e.g.*, *United States* v. *Olympic Radio and Television*, 349 U.S. 232, 235; *New Colonial Co.* v. *Helvering*, 292 U.S. 435, 440; *Deputy* v. *du Pont*, 308 U.S. 488, 493, and that those provisions are to be closely construed, *e.g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265.

As *Healy* v. *Commissioner*, *supra*, 345 U.S. at 284 and n. 17, holds, the relevant provision here is that for the deduction of a loss, now Section 165(a) of the Internal Revenue Code of 1954. See G.C.M. 16730, XV–1 Cum. Bull. 179 (1936). Respondent may have its deduction only as allowed by this statutory provision. Although many of the provisions of section 165 relate to losses of capital assets, its rules provide the proper analogy for analysis of the present problem. The essential provision is section 165(b), which limits the loss that may be deducted to the taxpayer's adjusted basis in the item that is the subject of the loss. In this case the loss is not capital in na-

ture, but represents repayments of amounts received in the ordinary course of business.

Thus, the computation of the amount of deductible loss begins with the fact that the full amounts of respondent's 1958 refunds to customers were, in prior years, included in gross income.[8] That is not, however, the whole picture. After including these amounts as gross income, respondent claimed and was allowed a depletion deduction amounting to 27½ percent of the gross amount. In the case of losses of property the Internal Revenue Code, in provisions now found in section 1016(a)(2), requires that an appropriate adjustment in basis be made for deductions previously taken for a variety of purposes, including "depletion". Since respondent's depletion was measured by its prior gross receipts from its gas producing property, these gross receipts should be reduced by the previously claimed depletion in order to measure respondent's loss which section 165 allows it to deduct.

[8] Several courts of appeals have held that a "basis" exists for such an item only if the receipts have been reported in income for tax purposes. See, *e.g.*, *Johnson* v. *Commissioner*, 162 F. 2d 844 (C.A. 5); *Commissioner* v. *Timken*, 141 F. 2d 625, 627–628 (C.A. 6); *Crane* v. *Commissioner*, 68 F. 2d 640 (C.A. 1); *Doneghy* v. *Alexander*, 118 F. 2d 521 (C.A. 10); *Rains* v. *Commissioner*, 33 B.T.A. 1189; see, generally, 5 Mertens, *Law of Federal Income Taxation* (1964 ed. and cum. supp.) § 28.12. The Second Circuit, however, in *Bennet* v. *Helvering*, 137 F. 2d 537 (C.A. 2), held that there is a basis even if the taxpayer should have reported an item as income but innocently failed to do so. See, also, *Alsop* v. *Commissioner*, 290 F. 2d 726. Since respondent included its receipts in gross income in 1952 through 1957, the courts of appeals would agree that in this case the initial basis is the amounts received in these years.

This analysis, which was followed in the only other case that has considered the application of the "claim of right" rule to a depletion problem such as this case presents, *O'Meara* v. *Commissioner*, 8 T.C. 622, 632–635, is confirmed by *Arrowsmith* v. *Commissioner*, 344 U.S. 6. There this Court held that when a repayment is made, the tax consequences of the repayment depend upon the facts surrounding the original receipt. In that case, the taxpayers received sums in liquidation of a corporation, which were then taxable as a capital gain. Several years later the taxpayers were required to pay certain obligations of the corporation, because of their status as transferees of the corporate assets. Though in the later year there was clearly no "sale or exchange," which is the usual earmark of a capital gain or loss, the Court held that these repayments were deductible only as a capital loss, since they arose out of and were a consequence of the prior capital transactions.

*Arrowsmith* illustrates the principle that the deduction in the year of repayment is not to be viewed in isolation without regard to all the steps in the transaction involved, and it also demonstrates that the deduction must be consistent with the tax treatment of the income in the prior years. Thus, if the taxpayers in *Arrowsmith* had been allowed an ordinary loss, as contended by them, they would have received an ordinary deduction for 100 percent of an amount which had been taken into income for prior years on the special basis applicable to capital gains.

The repayment in this case was of an amount previously received from the production of natural gas; it

was included in "the gross income from the property" which section 613(a) makes the basis for the percentage depletion allowed upon the production of natural gas. The result was that in the years 1952 through 1957 respondent had taken into taxable income only 72½ percent of the amounts received in those years. When these amounts were refunded in 1958, the loss deduction then should take into account these antecedent facts, as *Arrowsmith* illustrates. An unqualified 100 percent deduction such as respondent seeks here was not permitted in *Arrowsmith,* and for like reasons it is not permissible here.

C. THE RULE FORBIDDING DOUBLE DEDUCTIONS REQUIRES THAT RESPONDENT'S DEDUCTION BE LIMITED TO 72½ PERCENT OF THE AMOUNTS REPAID TO CUSTOMERS IN 1958.

In a large group of cases the courts have held that a taxpayer may not take more than one deduction with respect to the same money payment. *Ilfeld Co.* v. *Hernandez,* 292 U.S. 62, is particularly relevant. In that case, a parent corporation, for a number of years filed consolidated tax returns with two subsidiaries. Over the years, the subsidiaries' losses exceeded their profits, and those losses, through use of the consolidated returns, were used to diminish the parent's taxable profits. Then the subsidiaries' assets were sold, their debts paid, and the balance paid to the parent in cancellation of its stock. The parent sought to claim a loss deduction in the amount by which its basis in the stock exceeded the funds distributed on liquidation. Pointing to the fact that the subsidiaries' losses, which had been claimed as deductions on the consolidated

tax returns, had caused the diminution of assets that resulted in the parent's loss when the subsidiaries were liquidated, this Court rejected the parent's claim to a loss deduction upon liquidation. It said (292 U.S. at 68):

> If allowed, this would be the practical equivalent of double deduction. In the absence of a provision of the Act definitely requiring it, a purpose so opposed to precedent and equality of treatment of taxpayers will not be attributed to lawmakers. Cf. *Burnet* v. *Aluminum Goods Co.*, 287 U.S. 544, 551. *United States* v. *Ludey*, 274 U.S. 295, 301. There is nothing in the Act that purports to authorize double deduction of losses or in the regulations to suggest that the commissioner construed any of its provisions to empower him to prescribe a regulation that would permit consolidated returns to be made on the basis now claimed by petitioner.

*United States* v. *Ludey*, 274 U.S. 295, on which *Ilfeld* relies, is also pertinent here. The question in that case was the basis to be used for computing the taxpayer's gain upon the sale of real property with respect to which depletion had previously been claimed and allowed. The transaction took place before the adoption in 1924 of the first predecessor[4] of section 1016(a)(2), so that there was then no express statutory provision requiring that basis be reduced in the amount of depletion claimed and allowed. This Court nevertheless unanimously held that the basis must be so reduced, saying that (274 U.S. at 301) "[a]ny

[4] See section 202(b) of the Revenue Act of 1924, 43 Stat. 253, 255.

other construction would permit a double deduction * * *." This rule has long been incorporated in the Treasury Regulations. Thus, Section 1.1016-6(a) of the Regulations under the 1954 Code requires that "[a]djustments [to basis] must always be made to eliminate double deductions or their equivalent." See, also, Regulations 86 under the Revenue Act of 1934, Article 113(b)-1, at p. 198.

This policy against double deduction is expressly written into part of section 1341, with which the present case is most directly concerned. Section 1341(b)(3), added to section 1341 in 1958, 72 Stat. 1647, provides:

> If the tax imposed by this chapter for the taxable year is the amount determined under subsection (a)(5), the deduction referred to in subsection (a)(2) shall not be taken into account for any purpose of this subtitle other than this section.

Thus Congress emphasized that a taxpayer who chose to make use of the new procedure allowed by section 1341(a)(5) could not also lay claim to the equivalent of a double deduction by invoking the rule of *Healy* and *Lewis*, which are codified in section 1341(a)(4).

A similar policy is expressed in the committee reports on section 1341, in yet another context. Various deductions—for example those for charitable contributions—are limited to a percent of gross income. A taxpayer who returns as gross income an amount received under a claim of right thereby increases the limit on the amount of such deductions that he may claim. The problem arises if he claims the maximum of such a

deduction for a taxable year, and later restores or repays an amount received under a claim of right and included in gross income for that year. If he then takes the option provided in section 1341(a)(5), he may receive an excessive deduction for such items—unless he also is required to adjust his earlier charitable and similar deductions. Both the House Ways and Means Committee and the Senate Finance Committee had this to say about such a prospect (H. Rept. No. 1337, *supra,* at p. A294; S. Rept. No. 1622, *supra,* at p. 452):

> In computing the tax reduction for the prior taxable year attributable to the removal of the item in question, if the earlier year would otherwise be closed, no other items may be adjusted. However, to the extent that adjusted gross income or taxable income may be changed, items such as the medical and charitable deductions which are dependent upon income may also be affected.

This view has been expressly incorporated in the Treasury's Regulations on Income Tax, Section 1.1341–1(d)(4) (Appendix, *infra,* pp. 33–34).

In these materials, the Congress and the Treasury have dealt with the more obvious procedures by which the taxpayer might seek a double deduction through invoking section 1341. No one had foreseen the need to comment on or specifically provide for the present situation. But as the above quoted portions of the Committee reports imply, Congress expected that established, general principles would forestall any attempt to claim (292 U.S. at 68) "the practical equivalent of double deduction" through reliance on section 1341(a)(4).

Section 1341 must be construed in a sensible manner, and not, as the court of appeals has here, as opening up a wholly unintended and unnecessary loophole in the statute by reading its language "so broadly * * * as to defeat rather than further the purpose of Congress"—which, as this Court has said, cannot be justified. *Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 52; *Burnet* v. *Harmel,* 287 U.S. 103, 108. Notwithstanding the clear, overriding principle that double deductions are not to be allowed, and the expression of a legislative intent to apply to section 1341 the principle that forbids double deductions, the court below and respondent would impute to Congress an intention not only to compensate the taxpayer adequately for the tax paid in the prior years, which is clearly the purpose of section 1341 in general and section 1341(a)(5) in particular, but also an intention to go far beyond such compensation and grant to it by section 1341(a)(4) what amounts to a double deduction for depletion.

This is precisely the effect of the decision below. First respondent claimed and was allowed the 27½ percent depletion deduction when its customers' payments were received. Now the court of appeals has allowed respondent to deduct the full amount of the repayment in 1958, including the entire amount previously claimed and allowed as depletion. In this Court's words in *Ilfeld,* it has allowed "the practical equivalent of double deduction," for the effect of the court of appeals decision is to allow a natural gas producer which makes such a refund to claim total tax deductions of $1.275 for every dollar refunded to customers. In terms of tax liability, respondent pays less than it

would have if it had never included the receipts in its income; having originally paid some $190,000 in taxes with respect to the overcharges, it has been granted a refund of $263,000 in a later year, even though tax rates and all other relevant principles of law remained the same throughout the period. Any producer in the same situation may achieve a comparable tax windfall. This exceptional result, which Congress plainly did not intend, and which finds no warrant in the language of section 1341 or any other provision of the revenue laws, can be avoided only if respondent's deduction is limited to that amount which will avoid a double deduction, and that is 72½ percent of the 1958 repayments.

D. IN THE ALTERNATIVE, IF RESPONDENT IS ENTITLED TO A DEDUCTION IN THE FULL AMOUNT OF ITS REPAYMENTS TO ITS CUSTOMERS, IT MUST INCLUDE IN ITS GROSS INCOME AN AMOUNT EQUAL TO THE DEPLETION PREVIOUSLY CLAIMED AND ALLOWED WITH RESPECT TO THE AMOUNTS REFUNDED

The problem of this case may be analyzed in a somewhat different manner, which reaches essentially the same result. Thus, respondent's repayment might be treated by allowing a deduction for the full amount repaid, but requiring the restoration of the percentage depletion to income in the year of repayment. Though the earlier depletion deduction was correct when made, the eventual repayment established the fact that no percentage depletion deduction was in fact allowable. There was, to this extent, no eventual receipt from the production of gas, and under proper principles of tax accounting, the amount of percentage depletion previously deducted should be restored to income.

This analysis rests on the "principle * * * well engrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery." *Alice Phelan Sullivan Corp.* v. *United States,* 381 F. 2d 399, 401 (Ct. Cl.). This principle finds expression in a variety of cases dealing with circumstances where a taxpayer in one year obtains a refund of an amount that it had earlier paid out and claimed as a deduction in computing its federal income tax liability for a prior year, or where, in some manner, circumstances that come to pass in one year show the impropriety of a deduction that was claimed and allowed in an earlier year, and which had seemed proper on the basis of the facts as they then existed. In these circumstances, the courts of appeals and the Court of Claims have ruled that the gross income of the later years must be increased in the amount of the deduction previously claimed.

One case deals with the return to a taxpayer of property that was previously given to a charity and made the subject of a charitable deduction. *Alice Phelan Sullivan Corp.* v. *United States, supra.* Others deal with the refund of excise or other taxes that have previously been deducted as a business expense. *E.g., Freihofer Baking Co.* v. *Commissioner,* 151 F. 2d 383, 386 (C.A. 3); see also *Union Trust Co. of Indianapolis* v. *Commissioner,* 111 F. 2d 60 (C.A. 7), certiorari denied, 311 U.S. 658. Another group of cases reach a like result where an accrual has been made, and deducted, for wages, and the wages then go unclaimed. *Chicago, R.I. & P. Railway Co.* v. *Commis-*

*sioner*, 47 F. 2d 990 (C.A. 7), certiorari denied, 284 U.S. 618; *Charleston and Western Carolina Railway Co.* v. *Burnet*, 50 F. 2d 342 (C.A. D.C.). Similarly, when an amount previously deducted as a reserve for bad debts is found to be excessive in a later year, the excess amount must be included in income in that year. *Arcadia Savings and Loan Assn.* v. *Commissioner*, 300 F. 2d 247 (C.A. 9). Similarly, even before any statute so provided, where an insurance company's previously deducted reserves were excessive, and they were, accordingly, reduced, the amount of the reduction becomes taxable income. See *Maryland Casualty Co.* v. *United States*, 251 U.S. 342, 351–353; L.O. 1032, 2 Cum. Bull. 216; see also *Massachusetts Protective Association* v. *United States*, 114 F. 2d 304, 312–313 (C.A. 1); *Sneed* v. *Commissioner*, 119 F. 2d 767, 771 (C.A. 5).

The result is always the same. The prior deduction must be restored to income, at least where a tax benefit was received from the deductions, as was the case here. This Court expressly stated its agreement with this view in *Rothensies* v. *Electric Storage Battery Co.*, 329 U.S. 296, 298; cf. *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281.

The application of the rule to the present case is illustrated by the Court of Claims' recent decision in *Alice Phelan Sullivan Corp.* v. *United States, supra.* The problem in *Sullivan* involved the return to a taxpayer of property that had previously been given, in two parts, to a religious organization and each part had been the subject of a charitable deduction. Although the parties agreed that the return of the property should result in an addition to income for

the later year, in the amount of the deductions earlier claimed and allowed, the taxpayer contended that its tax could be increased by no more than the amount by which its tax was reduced by reason of the earlier charitable deductions. The Court of Claims disagreed, and, relying on such cases as *Rothensies* v. *Electric Storage Battery Co., supra,* sustained the government's contention that the current year's tax rate was applicable to the full amount previously deducted.[7]

Here the general problem is much the same, except that the receipt of money rather than its disposition was the occasion for a deduction in an earlier year. Because that receipt represented part of respondent's gross income from the property, which gave rise to the depletion deduction, the repayments should result in the restoration to gross income of the depletion deduction of 27½ percent of the amount which was allowed when respondent first received the moneys under claim of right.

The present situation is also similar to the one in *Douglas* v. *Commissioner,* 322 U.S. 275, where the taxpayers were the lessors of an iron ore mine, and the lessee guaranteed them minimum royalties. The lessee paid the minimum royalties each year but removed no ore at all, and at the end of eight years, the lease was cancelled. The taxpayers took depletion deductions in the years when the royalties were paid. A Treasury Regulation[8] required restoration of the deductions to

[7] In so doing, the court overruled its prior decision in *Perry* v. *United States*, 142 Ct. Cls. 7, 160 F. Supp. 270.

[8] Article 23(m)-10(c) of Treasury Regulations 94, issued pursuant to Section 23(m) of the Revenue Act of 1936, c. 690, 49

income in the year of termination of the lease, since there had been no production and the ore in taxpayer's mine remained unimpaired. The taxpayers contended that the regulation was invalid, but this Court upheld and enforced it.[9]

The right to depletion rests on extraction of a mineral and the amount of the allowance under section 613 is a percentage of the "gross income" resulting from the extraction. Just as the depletion is restored to income when, as in *Douglas*, attempts at extraction are abandoned in a year after the income has been received and reported, see *e.g.*, *Freeman* v. *Commissioner*, 48 T.C. 96, respondent should be required to make an adjustment for depletion taken in prior years since it later developed that part of the gross income—that which formed the basis of the depletion claimed—had to be refunded.

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At the time our petition for certiorari was filed here, there was no Treasury Regulation bearing directly on the problem, as there was in *Douglas*. Since that time, the Treasury has published, in 33 Federal Register 10700, July 26, 1968, a comprehensive set of proposed regulations designed to provide uniform rules with respect to a variety of depletion problems. One of those proposals deals specifically with the problem of this case. It provides as follows:

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Stat. 1648. It is now section 1.612–3(b)(2) of the Treasury Regulations on Income Tax under the 1954 Code.

[9] On one aspect of the *Douglas* case, relating to "tax benefit," the Court was equally divided. 322 U.S. at 287. But on the basic issue, relating to the restoration to income of the previously deducted depletion. The vote was six to two in favor of the propriety of the restoration.

SEC. 1.613–2 *Percentage depletion rates.*

* * * * *

(c) *Rules for application of paragraph (a) of this section.* * * *

* * * * *

(8) If the taxpayer restores or repays amounts included in gross income from the property for a prior year as part of the actual or constructive selling price of ores or minerals, then the amount of any deduction otherwise allowable on account of such restoration or repayment shall be decreased to the extent that a deduction for percentage depletion with respect to the amounts previously included in income, but subsequently restored or repaid, reduced taxable income in such prior year or years (either directly or indirectly as, for example, as part of a net operating loss deduction). See § 1.611–0. If appropriate, a corresponding adjustment shall be made to capital account. Examples of instances in which this subparagraph shall apply are payments made as a result of a court decision, the settlement of a claim, or a voluntary repayment.

This proposed regulation provides in effect that the deduction otherwise allowable under section 1341 (a)(4) shall be reduced by the percentage depletion allowed in previous years, if the depletion reduced taxable income in the previous years.

The proposed regulation is essentially clarifying in nature, and is intended as an analogue to the regulation sustained in *Douglas*. The Treasury, sustained as we have shown by long established rules of tax accounting, would use its authority to provide by regula-

tion for the computation of depletion (section 611(a)) "according to the peculiar conditions in each case" so as to forbid the result reached in the court of appeals. We, of course, cannot rest on this proposal, and if it is adopted as a regulation, its validity may well turn on the outcome of the instant case. It serves, however, to emphasize, through the expression of the administrative agency to whom Congress has granted particularly broad authority to define and delimit the depletion deduction, the validity of our contentions here. In the circumstances of this case, no less than in *Douglas,* the authorities provide an ample basis for denying the windfall that respondent claims, the grant of which would be inconsistent with the function and purpose of the depletion allowance.

## CONCLUSION

The judgment below should be reversed, and the judgment of the district court reinstated.

Respectfully submitted.

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# APPENDIX

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate.

* * * * *

(26 U.S.C. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * * * *

(26 U.S.C. 613.)

SEC. 1341. COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT.

(a) *General Rule.*—If—

(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

(3) the amout of such deduction exceeds $3,000,

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to—

(A) the tax for the taxable year computed without such deduction, minus

(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

* * * * *

Treasury Regulations on Income Tax (1954 Code):

§ 1.1341–1 *Restoration of amounts received or accrued under claim of right.*—(a) *In general.*—

(1) If, during the taxable year, the taxpayer is entitled under other provisions of chapter 1 of the Internal Revenue Code of 1954 to a deduction of more than $3,000 because of the res-

toration to another of an item which was included in the taxpayer's gross income for a prior taxable year (or years) under a claim of right, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the tax provided in paragraph (b) of this section.

(2) For the purpose of this section "income included under a claim of right" means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item, and "restoration to another" means a restoration resulting because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item (or portion thereof).

* * * * *

(b) *Determination of tax.*—(1) Under the circumstances described in paragraph (a) of this section, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year shall be the lesser of—

(i) The tax for the taxable year computed under section 1341(a)(4), that is, with the deduction taken into account, or

(ii) The tax for the taxable year computed under section 1341(a)(5), that is, without taking such deduction into account, minus the decrease in tax * * * for the prior taxable year (or years) which would result solely from the exclusion from gross income of all or that portion of the income included under a claim of right to which the deduction is attributable. * * *

(d) *Determination of decrease in tax for prior taxable years.*—* * *

* * * * *

(4) *Computation of amount of decrease in tax.*

* * * * *

(ii) No item other than the exclusion of the income previously included under a claim of right shall be considered in computing the amount of decrease in tax if reconsideration of such other item is prevented by the operation of any provision of the internal revenue laws or any other rule of law. However, if the amounts of other items in the return are dependent upon the amount of adjusted gross income, taxable income, or net income (such as charitable contributions, foreign tax credit, deductions for depletion, and net operating loss), appropriate adjustment shall be made as part of the computation of the decrease in tax. For the purpose of determining the decrease in tax for the prior taxable year (or years) which would result from the exclusion from gross income of the item included under a claim of right, the exclusion of such item shall be given effect not only in the prior taxable year in which it was included in gross income but in all other prior taxable years * * * affected by the inclusion of the item (for example, prior taxable years affected by a net operating loss carryback or carryover or capital loss carryover).

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